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In the Supreme Court of the United States

October Term, 1939

No. 146

Joseph T. Higgins, Collector of Internal Revenue for the Third District of New York, petitioner

v.

John Thomas Smith

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

In the District Court, the case was submitted to a jury and a judgment based upon the verdict was entered May 10, 1938 (R. 17). The opinion of the Circuit Court of Appeals (R. 338–340) is reported in 102 F. (2d) 456.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 29, 1939 (R. 341). The petition for certiorari was filed June 28, 1939, and was

granted October 9, 1939. The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer is entitled to deduct a "loss" arising out of an alleged sale, without any business purpose, of securities to a corporation wholly owned and controlled by the taxpayer.

STATUTE INVOLVED

Revenue Act of 1932, c. 209, 47 Stat. 169:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME. In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (e) *Losses by Individuals.*—Subject to the limitations provided in subsection (r) of this section, in the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—
>
> (1) if incurred in trade or business; or
>
> (2) if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *

STATEMENT

On December 29, 1932, the respondent, John Thomas Smith, made a purported sale of securities to his wholly owned corporation, the Innisfail Corporation. Those securities had cost him $234,002.31 (R. 4), and the stated price at which he under-

took to sell them to his corporation was $60,923.80 (R. 4). He claimed the difference as a "loss" in computing his net income for tax purposes. The Commissioner of Internal Revenue ruled against him, whereupon respondent paid the tax and brought suit for refund in the United States District Court for the Southern District of New York, where the case was tried before a jury.

The full import of the transaction here in question and the significance of the proceedings below will perhaps be made clearer by a somewhat detailed consideration of the circumstances in which Innisfail was created and of its prior transactions with the taxpayer.

1. *Creation of Innisfail.*—On June 14, 1926, taxpayer caused the formation of Innisfail Corporation, paying the expenses attending its formation, and providing "dummy" incorporators, individuals who were on the legal staff of General Motors Corporation and thus subordinates of taxpayer, general counsel of that corporation (R. 19, 34, 32).

On June 15, 1926, Messrs. Russo, Hogan, Gaynor, and Carroll, all subordinates of taxpayer, three of whom were incorporators, executed letters of resignation from their positions as directors and officers to take effect upon the acceptance of the board of directors of Innisfail Corporation (R. 42). Taxpayer became president and a director of Innisfail Corporation on March 12, 1927 (R. 208–209), and, with Mr. Russo and Mr. Hogan, constituted the board of directors from that time through

the year 1932 (R. 74-75). During all of that time, Mr. Russo's resignation as a director was pending subject to action by the board of directors (R. 75).

All of the stock of Innisfail was issued to taxpayer, save a few shares, issued to these subordinates to qualify them as directors, which were promptly endorsed over to taxpayer (R. 34). As consideration for the stock of Innisfail Corporation, taxpayer allegedly transferred to it his rights under an option agreement (R. 34, 155-156). There seems to be some question as to whether the option was exercised by the taxpayer prior to the creation of the corporation, but in any event the gain realized upon the exercise of the option was attributed to the corporation for tax purposes in 1926.

Pursuant to this option agreement (R. 305) between taxpayer and a Mr. Bassett, taxpayer had the right to exchange 5,005 shares of Chrysler preferred for 26,477 shares of Chrysler common (R. 66). Prior to June 14, 1926, when Innisfail Corporation was formed, taxpayer had standing in his own name and in his possession the 26,477 shares of Chrysler common, and Mr. Bassett had the 5,005 shares of Chrysler preferred, at least as collateral under the option agreement (R. 157). On the books of Innisfail, a gain of $515,000 was recorded as the result of the exchange of 5,005 shares of Chrysler preferred for 26,477 shares of Chrysler common (R. 103). With money furnished by the taxpayer, Innisfail paid taxes of about $69,000 on

such gain (R. 104–105). The tax to an individual with respect to the profit realized by Innisfail during that year would have been about $127,000 [1] (R. 103, 107).

The 26,477 shares of Chrysler common stock received in exchange for 5,005 shares of Chrysler preferred were not transferred out of the name of the taxpayer into that of Innisfail Corporation (R. 36). There was no corporate resolution authorizing the taxpayer to act as nominee for the 26,477 shares of Chrysler common stock (R. 36).

2. *Purposes and operations of Innisfail.*—The Innisfail Corporation was formed by taxpayer for the purpose of avoiding inheritance and income taxes (R. 35). At the time he formed the Innisfail Corporation, he had in mind the taxable gain which would accrue from the exchange of Chrysler preferred for Chrysler common (R. 35). And he knew that a corporation would not pay a tax on its income which an individual would have had to pay as a result of the dividend payments on the Chrysler stock contributed by him to Innisfail Corporation (R. 49).

When Innisfail Corporation opened a bank account in 1927, a resolution authorized the president (taxpayer) to borrow money and to obtain credit for the corporation with the bank on such terms

[1] That figure includes, in addition to the tax with respect to the $515,000 gain on the exchange of the Chrysler securities, the tax on about $39,000 dividends paid thereafter upon the securities received in exchange (R. 103, 107).

as might seem to him advisable, and authorized payment from the corporate funds on its check signed by him (R. 45–46).

A resolution adopted November 28, 1929 (R. 63), authorized the president "to sell any and all of the securities owned by this corporation at such time and upon such prices, terms, and conditions as he may see fit." No officer other than the taxpayer ever purchased or sold securities for Innisfail Corporation (R. 61). There was no instance where the board of directors did not agree with the position of the taxpayer as to the purchase and sale of stock for the corporation (R. 61, 75). At the end of December 1932 Innisfail Corporation had investments in 11 issues of securities, which were carried at a value of $791,751.92, and of that amount all, except securities having a value of approximately $30,000, were acquired by the corporation from the taxpayer (R. 54, 73).

No one but the taxpayer ever advanced money to, or withdrew money from, Innisfail Corporation (R. 55). Innisfail Corporation had no telephone, office space, or official stationery other than those used by the taxpayer personally (R. 63). It paid no rent (R. 60). Prior to 1934, it had no safe-deposit box in its own name (R. 116). It had no creditors other than the taxpayer (R. 55, 73). It had no pay roll save payments to Mr. Doty, the taxpayer's secretary, for part-time services; it paid no salaries to officers (R. 60, 73).

After testifying that no resolution authorized the taxpayer to act as nominee for Innisfail Corporation, the taxpayer explained (R. 36) that Innisfail Corporation "was a very informal corporation. Everybody in the Innisfail Corporation knew what the situation was and approved of the method of doing business and what was done." The taxpayer further testified that when the Innisfail Corporation was about to lend money to taxpayer, there was no formal meeting to discuss the matter; that the corporation's situation and affairs were known and approved by all the officers and directors, and that this "was an informal corporation" (R. 62).

Taxpayer disposed of his interest in the Innisfail Corporation to members of his family on December 22, 1934 (R. 29), subsequent to the passage of the Revenue Act of 1934, *infra.*

3. *Earlier Transactions.*—During the years 1926 to 1931, approximately $400,000 was paid to taxpayer as dividends on the Chrysler stock, standing in his name, the option rights to which he had transferred to Innisfail in exchange for its stock. These dividends were received by the taxpayer personally and the funds were used by him (R. 44, 46, 48, 49, 51, 53, 265–267). Entries were made on taxpayer's books and on the books of Innisfail Corporation indicating that the taxpayer owed Innisfail the amount of dividends received in such manner (R. 44, 265). In 1932, taxpayer ordered

the Chrysler Corporation to pay to Innisfail dividends on Chrysler stock owned by Innisfail and standing in the name of the taxpayer (R. 52).

On December 6, 1929, Innisfail Corporation sold to taxpayer 4,412 shares of Chrysler stock and as the result of such sale to him a loss of $139,000 was reflected on its income-tax return (R. 88-89). Innisfail had acquired these 4,412 shares through the taxpayer on July 19, 1928, when the taxpayer had paid for the subscriptions to these shares issued in his name, the corporation owing him the amount of the subscriptions (R. 49, 91). Entries were made upon the books of the taxpayer and the corporation to reflect a debt from the sale of December 6, 1929, reducing the corporation's indebtedness to taxpayer (R. 48, 265).

On December 28, 1929, the taxpayer sold to Innisfail Corporation 1,000 shares of stock of Aldebaran Corporation for $160,800, and on December 31, 1929, 1,900 shares of stock of Hudson Motor Company for $106,400 (R. 49). Taxpayer reported a loss on these shares on his individual return (R. 49). He selected these securities in order to reflect a taxable loss (R. 63, 64). Innisfail Corporation at this time had no money with which to purchase such stock. The taxpayer caused entries to be made on his books and on the books of Innisfail Corporation to record the transactions of sale and increase the indebtedness of

Innisfail Corporation to the taxpayer (R. 50, 265). No note was executed, and no interest was charged (R. 50).

During 1930, dividends on the 1,900 shares of Hudson Motor stock which taxpayer had sold to Innisfail in 1929 were received in cash by him (R. 50). Entries in his books and the books of Innisfail would record a debt from him to the corporation in connection with the receipt by him of such dividends (R. 51).

On September 30, 1930, Innisfail Corporation sold to taxpayer, for $195,000, 10,000 shares of common stock of Chrysler Corporation, standing in his name (R. 50). This lot of 10,000 shares was part of the original block of 26,477 shares of Chrysler common previously described (*supra*, p. 4), which Innisfail had received in June of 1926 (R. 265–267). An entry was made on the taxpayer's books and the corporation's books to record the sale, and to evidence the debt due by taxpayer, converting a debt due from Innisfail to the taxpayer into a debt owing by taxpayer to Innisfail (R. 50, 267). Taxpayer did not execute a note to the corporation, nor did it charge him interest (R. 50).

The taxpayer owed $68,364.68 to Innisfail on December 29, 1932, as the result of items reflecting the various transactions between them, principally those set out above (R. 26). There were balances due between them at the end of each year, Innisfail

owing money through September 1930, and taxpayer owing money thereafter. No note was ever executed by Innisfail Corporation to the taxpayer nor by him to the corporation; nor was any interest charged by either on balances outstanding (R. 47, 48, 50, 51).

4. *The Transaction in Question.*—On December 29, 1932, the taxpayer caused certain of his personal securities to be transferred into the name of Innisfail Corporation. These securities consisted of the following (R. 4):

500 shares Electric Auto-Lite Company.
500 shares Firestone Tire & Rubber Company.
332 shares Gaynor Electric Company.
1,553 shares Investrad Corporation.
18,324 shares National Baking Company.
200 shares National Sugar Refining Company.

Prior to the transaction, the taxpayer had unrealized losses on these personal securities. When he picked these securities, he had in mind the tax consequences of their selection for sale (R. 63, 64). His indebtedness to Innisfail at that time was $68,364.68, and the securities which he selected for transfer to Innisfail had an aggregate market or book value of $60,923.80 (R. 26, 64, 4).

The taxpayer was given credit on the books of Innisfail in the amount of $60,923.80, the sales price determined upon for these securities, fixed at their market or book value (R. 4, 30–31). He

then gave to Innisfail a check for $7,440.88 (R. 26, 51, 99), which represented the difference between the value of the securities and his alleged debt to Innisfail.

The securities were kept in a safe-deposit box which was not in the name of Innisfail (R. 33, 44, 116). Innisfail received the dividends paid on them (R. 77, 125–126, 128, 129). It did not reconvey any of such securities to the taxpayer (R. 24).

5. *The Proceedings Below.*—The District Court charged the jury (R. 159–174) that the jury was to determine whether the transfers were to an entity which had an existence and identity separate and apart from the taxpayer (R. 165–166), but definitely stated to the jury that the mere fact that taxpayer owned all the stock did not prove that the corporation did not have such separate existence (R. 166). The jury was instructed (R. 167) not to draw any unfavorable inference because of any tax avoidance motive on the part of the taxpayer. The court charged that the mere fact that a corporation does business only with its sole stockholder is not enough to deny its separate existence, but that this is a circumstance the jury is entitled to consider in ascertaining whether there was in truth and fact an actual and substantial sale or group of sales involved in this case (R. 172).

Finally, the court charged that the losses contemplated by the tax laws were actual and real and sustained in a transaction having a regular busi-

ness purpose (R. 173); that a mere gesture without the vital intent to change ownership is not to be recognized as a sale because it has some of the appearances of a sale (R. 173); that the property after being sold must be outside the control and domination of the seller and outside his power of disposition (R. 173).

After considering the evidence and the inferences to be drawn therefrom, in the light of the court's instructions, the jury returned a general verdict for the Government on the issue here involved [2] (R. 176). The Circuit Court of Appeals ruled that the taxpayer's motion for a directed verdict should have been granted. It reversed the judgment and remanded the cause. It originally directed entry of verdict for the taxpayer (R. 342–346), but on motion for rehearing directed a new trial (R. 341).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the taxpayer's motion for a directed verdict should have been granted.

2. In holding that a sale to a corporate entity must be recognized for tax purposes regardless of the nature of the corporation or the reality or business substance of its transactions.

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[2] The jury returned a verdict for the taxpayer with respect to the fraud penalty imposed by the Commissioner (R. 176).

3. In holding that a loss is sustained upon a sale to a corporation, which is wholly owned and controlled by the vendor, was formed and used to avoid taxes, and has engaged in transactions practically with the vendor alone, the sale having no business purpose.

4. In limiting the principles enunciated in *Gregory* v. *Helvering*, 293 U. S. 465, strictly to a reorganization case.

5. In holding that there was no evidence or legitimate inference to support the verdict of the jury on the question of the reality or finality of the alleged sale of securities by the taxpayer to his wholly owned corporation.

6. In weighing the evidence and in reaching a conclusion upon the facts (that there was an actual sale) contrary to that reached by the jury.

7. In reversing the judgment of the trial court and in remanding for a new trial.

SUMMARY OF ARGUMENT

I

The transactions here under review are outside the scope of Section 23 (e) which grants deductions for losses "sustained" during the taxable year. Those provisions contemplate that a deductible loss must be realized by some closed event determining the existence and amount thereof, and that a "sale" may constitute such a closed event only where there is a final disposition of the

property in question. It is our position that a purported sale of securities, without any business purpose, to a wholly owned corporation cannot, as a matter of law, be such a final disposition as to create a realized loss. In such a situation the taxpayer in every practical sense retains full dominion and all the advantages of ownership over the securities which he has purported to sell. Loss deductions are granted by Congress as a matter of grace, and this Court has held that to be deductible the loss must be actual, present, and real.

There is an abundance of authority, of which *Gregory* v. *Helvering*, 293 U. S. 465, is a striking example, to the effect that a mere ritualistic compliance with the literal terms of the statute will not suffice to give the taxpayer hoped-for advantages that Congress plainly intended for others. Both the corporate reorganization provisions involved in the *Gregory* case and the loss provisions herein were aimed at alleviating the taxpayer's burden. To grant the loss deduction under circumstances where no real loss has been sustained would be to pervert the purpose of these provisions in the same manner that the taxpayer unsuccessfully attempted by ingenious manipulation to misuse the reorganization provisions in the *Gregory* case.

II

In any event, even if a sale without business purpose to a wholly owned corporation is not, as a matter of law, outside the scope of Section 23 (e),

the particular "sales" involved herein do not constitute deductible losses. The District Judge instructed the jury to determine whether there was in fact an actual sale, and he charged that a mere gesture without the vital intent to change ownership is not to be recognized as a sale merely because the transaction has some of the appearances of a sale. The jury's general verdict for the Government represents a finding that there were no genuine sales, that the taxpayer had no real intention of relinquishing dominion over the securities—a finding similar to that in *Mitchell* v. *Commissioner*, 89 F. (2d) 873, 874–875 (C. C. A. 2d), certiorari denied, 302 U. S. 723 (reversed on other grounds, *sub nom. Helvering* v. *Mitchell*, 303 U. S. 391), where sales between husband and wife were held to be spurious. The Circuit Court of Appeals was therefore without power to overthrow that verdict, which was supported by so overwhelming a mass of evidence.

ARGUMENT

Introductory.—The Government's position in this case rests upon two independent grounds. First, we will contend that, as a matter of law, no deduction is allowable under Section 23 (e) where a taxpayer transfers securities without any business purpose to a wholly owned corporation; that such a transfer, even though technically a sale, is nevertheless not such a final disposition of those securities as to bring about a "loss" within the meaning of Section 23 (e). Second, we will

contend that there was not even a "sale" to the wholly owned corporation; that evidence was adduced before the jury tending to show the absence of a genuine sale (compare *Mitchell* v. *Commissioner,* 89 F. (2d) 873, 874–875 (C. C. A. 2d), certiorari denied, 302 U. S. 723 (reversed on other issues, *sub nom. Helvering* v. *Mitchell,* 303 U. S. 391), involving spurious sales between spouses), and that in the light of that evidence the verdict of the jury should not have been upset by the Circuit Court of Appeals.

I

A SALE WITHOUT BUSINESS PURPOSE TO A WHOLLY OWNED CORPORATION CANNOT, AS A MATTER OF LAW, GIVE RISE TO A DEDUCTIBLE LOSS

1. The alleged sales of securities to Innisfail, organized and controlled throughout by the taxpayer for the purpose of avoiding taxation, having no business purpose, were not such sales as could give rise to such real losses as were contemplated by Congress in granting deductions from gross income. We submit that the Circuit Court of Appeals erred in concluding in effect that any formally complete sale is sufficient to produce a deductible loss, even though the sale be made to the taxpayer's wholly owned corporation, having no business purpose or activity other than the participation in the taxpayer's admitted scheme to avoid taxes.

At the very outset it should be observed that the taxpayer is here seeking the benefit of a deduction.

But "every deduction from gross income is allowed as a matter of legislative grace" (*White* v. *United States,* 305 U. S. 281, 292), and "only as there is clear provision therefor can any particular deduction be allowed". (*New Colonial Co.* v. *Helvering,* 292 U. S. 435, 440). See also *Woolford Realty Co.* v. *Rose,* 286 U. S. 319, 326. And where the taxpayer has boldly undertaken to create artificial losses by paper transactions, it is particularly important to keep in mind the recent words of this Court that "It is in the public interest that no one should be permitted to avoid his just share of the tax burden except by positive command of law." *Stone* v. *White,* 301 U. S. 532, 537. Cf. *Morsman* v. *Helvering,* 90 F. (2d) 18 (C. C. A. 8th), certiorari denied, 302 U. S. 701. We respectfully submit that such command is wholly lacking here.

Our argument on this branch of the case assumes that the court below was correct in holding that there was a fully completed sale of the stock to Innisfail, a legal entity separate from the taxpayer. But we insist that the Revenue Acts do not provide for recognition of a loss resulting from a transfer to a purchaser wholly owned and controlled by the seller, in a transaction having no business purpose or significance. The decision of the court below exalts form above substance in a way contrary to the purpose of the tax laws. Cf. *Gregory* v. *Helvering,* 293 U. S. 465, 470; *Minnesota Tea Co.* v.

Helvering, 302 U. S. 609, 613–614; *United States* v. *Phellis*, 257 U. S. 156, 168; *Lucas* v. *Earl*, 281 U. S. 111, 114; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330; *Gulf Oil Corp.* v. *Lewellyn*, 248 U. S. 71.

2. The transaction in the present case lies outside the plain scope of Section 23 (e) which allows the deduction from gross income of losses "sustained" during the taxable year. Under this section, losses must be realized by some closed and completed identifiable event determining the existence and amount of the loss. The loss must be a real loss, "actual and present." *Burnet* v. *Huff*, 288 U. S. 156, 161; cf. *Helvering* v. *Owens*, 305 U. S. 468. A taxpayer cannot claim a loss merely because his securities have declined in value. *New York Ins. Co.* v. *Edwards*, 271 U. S. 109, 116. Nor can he take the deduction by making a formal sale of the securities, retaining dominion and control (*Schoenberg* v. *Commissioner*, 77 F. (2d) 446 (C. C. A. 8th), certiorari denied, 296 U. S. 586), as through an understanding permitting him to repurchase (*Nicholson* v. *Commissioner*, 90 F. (2d) 978 (C. C. A. 8th); *Commissioner* v. *Dyer*, 74 F. (2d) 685 (C. C. A. 2d), certiorari denied, 296 U. S. 586; *Commissioner* v. *Riggs*, 78 F. (2d) 1004 (C. C. A. 3d), certiorari denied, 296 U. S. 637). Similarly in the case of a transfer without a business purpose to a wholly owned and controlled corporation (where any agreement to repurchase would be wholly unnecessary), there can be no deductible

loss. Compare *Powell* v. *Commissioner*, 94 F. (2d) 483 (C. C. A. 1st), involving a sale to a trust of which the taxpayer was the sole trustee. The taxpayer in every practical sense retains full dominion and all the advantages of ownership, while the corporation lacks even that independence of judgment which might be attributable to a wholly-owned corporation charged with the destiny of a separate business enterprise. The Revenue Act contemplates genuine losses, recognized as such by the business world, not fictitious losses resulting from transfers by the taxpayer to his incorporated pocketbook. Deductible losses might as well be allowed when the taxpayer on his books transfers an investment from one account to another.

This Court has made it clear that the loss provisions must be construed realistically; that in attempting to spell out a formula for loss deductions, Congress did not intend to permit such deductions where the taxpayer in reality suffers no loss; and that the statutory provisions should be interpreted in the light of that dominant purpose. Thus, in *United States* v. *Flannery*, 268 U. S. 98, the taxpayer had purchased securities prior to March 1, 1913, which he sold in 1919 for more than their cost but for less than their value on March 1, 1913. The applicable provisions of the Revenue Act of 1918 stated that in computing loss on sale of property acquired prior to March 1, 1913, the fair market value as of that date should be taken

as the basis. The taxpayer, applying these provisions literally, claimed a loss in the amount of the difference between the March 1, 1913, value and the sale price. This Court held, however, that since the sale price was in excess of taxpayer's original cost, no real loss had been sustained, and denied the deduction. A like result was reached in *McCaughn* v. *Ludington*, 268 U. S. 106.

In *Helvering* v. *Owens*, 305 U. S. 468, the taxpayer's property was destroyed by a casualty. The applicable statutory provisions allowed a loss deduction, in an amount based upon cost, if the provisions were to be read literally. However, this Court held that the taxpayer could deduct only the loss actually sustained, i. e., measured from the market value of the property immediately prior to destruction.

These cases demonstrate that in granting deductions on account of losses Congress was referring to genuine losses, and that the statutory provisions containing the allowance are applicable only where and to the extent that the losses are real.

The facts in the instant case strikingly reveal the absence of any genuine loss, and show that the so-called sales to Innisfail were really not such final dispositions of the securities as to entitle the taxpayer to his claimed deductions.

Innisfail was created and persistently used, with negligible exceptions, for the specific purpose of serving respondent in his efforts to avoid taxes.

In the year in question he realized large amounts of income that would ordinarily have been subject to tax unless offset by the phantom sales. While those sales may have been real in the narrow sense that title passed, they were wholly unreal in the sense that respondent never parted nor ever intended to part with his unfettered control over the securities in question.

Innisfail was obviously not organized for the purpose of trading in the outside business world. The record shows that it was created and used for an entirely different purpose. The trading was practically all with the taxpayer, who ignored the corporate entity in substantially every transaction he had with it. From the creation of Innisfail until the year in question the taxpayer took all the dividends and cash that came in, ignored the corporation's bank account, and appropriated the funds to his own uses; but at the same time he was able to place the dividends on the books as belonging to the corporation and avoid the surtax that he would have had to pay if he had returned them as his own (R. 44-51).

The taxpayer owned all of the stock in the corporation, and his codirectors were men employed in his office under him and subservient to him. They had no interest in the corporation and drew no salaries. They were dummy directors, acquiescent at all times to the taxpayer's wishes.

No one but the taxpayer ever advanced money to, or withdrew money from, Innisfail. Innisfail had no telephone, office space, or official stationery. It paid no rent. Prior to 1934, it had no safe deposit box in its own name. It had no creditors other than the taxpayer. It had no pay roll save payments to Mr. Doty, the taxpayer's secretary, for part-time services; it paid no salaries to officers. In the words of the taxpayer himself (R. 36), Innisfail Corporation "was a very informal corporation. Everybody in the Innisfail Corporation knew what the situation was and approved of the method of doing business and what was done."

It seems plain that, under these circumstances, a transfer of securities to respondent's alter ego could not, as a matter of law, constitute a final disposition of those securities for the purpose of establishing a deductible loss, and that the statutory provisions granting the deduction were never meant to apply to such an empty ritual. A contrary holding would mean that Congress in providing for the deduction of losses *sustained* during the taxable *year* was nevertheless willing to sanction so obvious a device for circumventing the condition it so carefully spelled out. And this Court has, on at least several comparable occasions, indicated that such a purpose is not to be imputed to Congress. *Woolford Realty Co.* v. *Rose*, 286 U. S. 319, 329–330; *Carbon Steel Co.* v. *Lewellyn*, 251 U. S. 501, 504. *Cf. Braden Steel Corp.* v. *Commissioner*, 78 F. (2d) 808, 810 (C. C. A. 10th).

3. In *Gregory* v. *Helvering*, 293 U. S. 465, the taxpayer's wholly owned corporation transferred securities to a new corporation, organized to avoid taxes, which issued all its shares to the taxpayer, and which was subsequently dissolved and liquidated by the distribution of the securities to the taxpayer. The Court held that although the transaction had the form of a corporate reorganization, it was without any business purpose and the nonrecognition provisions of the income-tax law were inapplicable. This principle was extended in *Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609, 613–614. Cf. *Helvering* v. *Elkhorn Coal Co.*, 95 F. (2d) 732 (C. C. A. 4th), certiorari denied, 305 U. S. 605; *Electrical Securities Corp.* v. *Commissioner*, 92 F. (2d) 593 (C. C. A. 2d); *Starr* v. *Commissioner*, 82 F. (2d) 964 (C. C. A. 4th); *S. Silberman & Sons* v. *Commissioner*, 76 F. (2d) 360, 362 (C. C. A. 7th); *S. A. MacQueen Co.* v. *Commissioner*, 67 F. (2d) 857 (C. C. A. 3d); *Helvering* v. *Gordon*, 87 F. (2d) 663 (C. C. A. 8th); *Pennsylvania Indemnity Co.* v. *Commissioner*, 77 F. (2d) 92 (C. C. A. 3d), certiorari denied, 296 U. S. 588; *Cogan* v. *Commissioner*, 36 B. T. A. 639, affirmed, 97 F. (2d) 996 (C. C. A. 2d).

In the *Gregory* case, there was a ritualistic compliance with the literal language of the statute, but this Court construed the reorganization provisions as referring only to reorganizations with a *business* purpose. The Court then examined the substance

of the situation and concluded that the corporation was nothing more than a contrivance (p. 469)—

> having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.

To paraphrase the above language, the corporation here was a contrivance or mere device which the taxpayer sought to employ as a transferee in a purported sale, disguising his real object of taking a loss on depreciated securities without in any way releasing those securities to the outside business world. The true character of the control reserved by him is apparent from the occasions in previous years when he reacquired title by the mere juggling of credit and debit entries.

The court below regarded *Gregory* v. *Helvering*, *supra*, as a decision of limited significance, stating that it "had to do with a pretended reorganization not within the scope of that statute" (R. 340). But the principle established in that case necessarily reaches beyond the particular section of the Revenue Act under which it arose.[3] There is no

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[3] A note of warning to taxpayers was sounded in this connection in Paul, *Studies in Federal Taxation* (1937), p. 149: "It should not be forgotten by taxpayers close to the line that the method of statutory interpretation adopted by the

reason why the reorganization provisions should be singled out for special treatment, and it would indeed be extraordinary if Congress had intended that a realistic approach be reserved exclusively for those provisions.

Both the reorganization and the loss provisions are aimed at relief from taxation, and it should not be presumed that Congress meant to grant such relief where none is called for by the facts at hand. The deduction on account of realized losses was intended to alleviate the taxpayer's burden. To grant it under circumstances where no loss has actually been *sustained* and where a wholly owned corporation is employed merely to give the appearance of a final disposition of the securities in question, would be, we submit, to pervert the purpose of those provisions. Both here and in the *Gregory* case the meaningless use of the corporate device in order to pay lip service to the statutory conditions should not and cannot entitle the taxpayer to the relief that was plainly intended for others.[4] There

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Supreme Court in the Gregory case with reference to the "reorganization" provision may be adopted by the Supreme Court and other courts in construing other provisions."

[4] The unduly narrow view which the Second Circuit has taken of the *Gregory* case is apparent from an extended dictum in *Electrical Securities Corp.* v. *Commissioner*, 92 F. (2d) 593, 595 (bottom of first column). The very situation which the court there discussed and stated to be outside the scope of the *Gregory* case was held to be within the principle of the *Gregory* case in *Helvering* v. *Elkhorn Coal Co.*, 95 F. (2d) 732 (C. C. A. 4th), certiorari denied, 305 U. S. 605, rehearing denied, 305 U. S. 670.

is nothing in the *Gregory* decision which even suggests that the reorganization provisions alone have a monopoly on this type of statutory construction.

The principle of the *Gregory* case has been applied in *Commissioner* v. *Griffiths*, 103 F. (2d) 110 (C. C. A. 7th), certiorari granted October 9, 1939. (No. 49, present Term). There the taxpayer, defrauded in a purchase of securities, was about to make a profitable settlement, and, in order to avoid taxes, first organized a wholly owned corporation and sold those securities, together with his cause of action, to the corporation on an installment basis. The court pointed out that the corporation had no legitimate business purpose of substantial character, relied upon the principle of the *Gregory* case instead of restricting it to its particular situation, and refused to permit the transfer to the wholly owned corporation to dictate tax consequences Accord: *Loewenberg* v. *Commissioner*, 39 B. T. A. 844. The applicability of the *Gregory* decision to a sale made to a controlled corporation in order to establish a loss is also indicated by *Wickwire* v. *United States*, 27 F. Supp. 724 (E. D. Mich.). And the number and range of cases outside the field of reorganizations that have treated the principle of the *Gregory* case as applicable are indeed impressive. See e. g., *Groves* v. *Commissioner*, 99 F. (2d) 179, 183 (C. C. A. 4th); *Continental Oil Co.* v. *Jones*, 26 F. Supp. 694, 699–704 (W. D. Okla.); *Jackson* v. *Commissioner*, 39 B. T. A. 937; *Slayton* v. *Commissioner*, 76 F. (2d) 497, 500 (C. C. A. 1st),

certiorari denied, 296 U. S. 586; *S. Silberman & Sons* v. *Commissioner,* 76 F. (2d) 360, 362 (C. C. A. 7th); *Nicholson* v. *Commissioner,* 90 F. (2d) 978, 980 (C. C. A. 8th); *Ossorio* v. *United States,* 18 F. Supp. 959, 964 (C. Cls.), certiorari denied, 302 U. S. 713; *Patty* v. *Helvering,* 98 F. (2d) 717, 719 (C. C. A. 2d); *Jones* v. *Page,* 102 F. (2d) 144, 145 (C. C. A. 5th), certiorari denied, October 9, 1939, No. 179, present Term; *Morsman* v. *Helvering,* 90 F. (2d) 18, 22 (C. C. A. 8th), certiorari denied, 302 U. S. 701.[5]

In the case at bar, as in the *Gregory* and *Griffiths* cases, the wholly owned corporation was formed to avoid taxes (R. 35, 49), and used for that purpose (R. 49, 64, 65). Although in the *Gregory* and *Griffiths* cases the corporation was formed to handle the particular transaction scrutinized by the court, it hardly can be deemed material that in the case at bar the corporation had been previously organized and had engaged in various transactions prior to 1932. If the principle of the *Gregory* case were limited to what might be called single-transaction corporations, it would place a premium on a protracted as opposed to a sporadic use of the corporate shell for tax-avoidance purposes.

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[5] However, in *Smith* v. *Commissioner,* 40 B. T. A. 387, involving the instant taxpayer's tax liability for prior years, the Board ruled against the Commissioner, over the protests of a vigorous dissent written by the Board member who heard the case and concurred in by ~~for~~ other members.
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4. Our position does not necessarily involve a disregard of the corporate fiction. It may be conceded, as in the *Gregory* case (p. 469), that when Innisfail was organized, a "valid corporation was created." And it may further be assumed *arguendo* that technical title actually passed to the corporation in the various sales which respondent undertook to execute to it. The gist of our position is that such "sales" did not and could not constitute such final dispositions of the securities so as to bring about a "loss" within the meaning of the statutory provisions. Our contention is therefore not in conflict with the results reached in such cases as *Dalton* v. *Bowers,* 287 U. S. 404; *Burnet* v. *Clark,* 287 U. S. 410; *Burnet* v. *Commonwealth Imp. Co.,* 287 U. S. 415; and *Klein* v. *Board of Supervisors,* 282 U. S. 19. In those cases, corporations were employed to conduct certain affairs, and this Court held that the taxpayers were bound by the tax consequences which flowed from the use of corporations. The Court there simply refused to disregard the corporate entity where those interested in the enterprise had selected the corporate form and were seeking to avoid the consequences of that choice. The instant case does not require a disregard of the corporate fiction; we merely urge that no deduction is given by Section 23 (e) under these circumstances.

But even if it were necessary to disregard the corporate fiction there is persuasive authority that

would justify such a course. In *McCaskill Co.* v. *United States*, 216 U. S. 504, 515, this Court noted a "growing tendency" to look beyond the corporate form. See also *United States* v. *Lehigh Valley R. R. Co.*, 220 U. S. 257, 272–274; *Chicago, M. & St. P. Ry. Co.* v. *Minn. Civic Assn.*, 247 U. S. 490, 500–501.[6] And in two cases arising under the first of our modern income tax statutes, this Court pierced the corporate veil. *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330; *Gulf Oil Corp.* v. *Lewellyn*, 248 U. S. 71.[7] In *New Colonial Co.* v. *Helvering*, 292 U. S. 435, where the taxpayer sought unsuccessfully to disregard the corporate entity, the Court nevertheless plainly stated that (p. 442):

> * * * the separate identity may be disregarded in exceptional situations where it otherwise would present an obstacle to the due protection or enforcement of public or private rights. * * *

We respectfully submit that the instant case presents just such a situation as was referred to in the *New Colonial Co.* decision, and that *Dalton* v. *Bowers*, 287 U. S. 404, and like cases are to be assimilated to the *New Colonial Co.* case itself.

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[6] Cf. *United States* v. *Reading Co.*, 253 U. S. 26; *Northern Securities Co.* v. *United States*, 193 U. S. 197; *Standard Oil Co.* v. *United States*, 221 U. S. 1, 75; *United States* v. *U. S. Steel Corp.*, 251 U. S. 417.

[7] Compare *Gardiner* v. *Treasurer & Receiver General*, 225 Mass. 355, where the court refused to take cognizance of a

5. The taxpayer may, perhaps, rely upon Section 24 (a) (6) of the Revenue Act of 1934 (c. 277, 48 Stat. 680)[8] which specifically provides that no deduction shall be allowed for loss from sales between an individual and a corporation in which he owns more than 50% in value of the outstanding stock; and may contend that the appearance of these new provisions in the 1934 Act should be taken as evidence that the contrary was the law prior thereto. However, we submit that the new

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specially created corporation for tax purposes, saying (p. 369):

"The identity of purpose and unity of interest whether the trustees are considered as administering the trust as individuals or as incorporated under the name of the Gardiner Investment Company, is complete. We are satisfied that in making these contracts they dealt with themselves and intended to retain and did retain full control of the legal title to the shares of stock which in reality comprised the trust property transferred to the petitioners as executors to be by them distributed to the legatees. * * *"

[8] Section 24 (a) (6) provides:

"SEC. 24. ITEMS NOT DEDUCTIBLE.

"(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

* * * * *

"(6) Loss from sales or exchanges of property, directly or indirectly, (A) between members of a family, or (B) except in the case of distributions in liquidation, between an individual and a corporation in which such individual owns, directly or indirectly, more than 50 per centum in value of the outstanding stock. For the purpose of this paragraph—(C) an individual shall be considered as owning the stock owned, directly or indirectly, by his family; and (D) the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants."

provisions have, at most, a doubtful bearing upon this case.

It is equally arguable that the new provisions, at least to the extent that they deal with a situation like the present one, are merely declaratory of existing law and simply clarify rather than change the law. *Helvering* v. *N. Y. Trust Co.*, 292 U. S. 455, 468–469; *Helvering* v. *Twin Bell Syndicate*, 293 U. S. 312, 322. Cf. *Keifer & Keifer* v. *R. F. C.*, 306 U. S. 381; *Hopkins Savings Assn.* v. *Cleary*, 296 U. S. 315, 333–335; *Burnet* v. *Guggenheim*, 288 U. S. 280, 287–288. While it is true that the committee reports accompanying the bill that became the Revenue Act of 1934 spoke of Section 24 (a) (6) as closing up possible "loopholes" (H. Rep. No. 704, 73d Cong., 2d Sess., p. 23; S. Rep. No. 558, 73d Cong., 2d Sess., p. 27), that purpose is nevertheless not contrary to our position here. An intention to close loopholes is equally consistent with uncertainty as to existing law and a sense of caution, as with an alleged recognition of the law's shortcomings. Indeed, it would be most ironical if the solicitude of Congress in meeting an evil with particularity should be taken to have foreclosed the consideration of doubts under existing law which might be resolved in accord with the law as enacted for the future.

Moreover, in some respects Section 24 (a) (6) actually goes far beyond existing law. It removes loss deductions in the case of all sales between members of a family. And in stating that no loss shall

be recognized in the case of sales or exchanges between an individual and his corporation, no distinction is drawn between sales which have a business purpose and those which have not. Further, Section 24 (a) (6) is operative even where the individual owns only 50% of the stock, and within that 50% may be included any stock owned by members of his family. Thus, in speaking of closing up "loopholes," the Congressional Committees were doubtless referring to those instances in which the new provisions plainly went beyond existing law. But in their broad sweep these new provisions undoubtedly embraced some situations which could be regarded as already covered by existing law, and we submit that the instant case presents such a situation.

II

THE CIRCUIT COURT OF APPEALS ERRED IN HOLDING THAT THERE WAS NO EVIDENCE OR LEGITIMATE INFERENCE TO SUPPORT THE VERDICT OF THE JURY ON THE QUESTION OF THE REALITY OR FINALITY OF THE ALLEGED SALES TO INNISFAIL

In Point I we contended that, as a matter of law, a sale without business purpose to a wholly owned corporation cannot produce a deductible loss. In somewhat similar manner we undertake to support the Government's position in *Griffiths* v. *Commissioner*, No. 49, and *Commissioner* v. *Johnson*, No. 317, urging that the issue involved is not one of fact but rather of the legal effect of the undisputed evidentiary facts and that such an issue is reviewable by an appellate court. Cf, *Helvering* v. *Tex-Penn*

Co., 300 U. S. 481, 491; *Helvering* v. *Rankin*, 295 U. S. 123, 131; *Bogardus* v. *Commissioner*, 302 U. S. 34, 39.

However, if we should be wrong on Point I and if this Court should hold that a sale without business purpose to a wholly owned corporation is not necessarily outside the loss provisions as a matter of law, then we will contend further in Point II that the particular "sales" here involved were really not sales at all, that the taxpayer at the time never intended to make any bona fide transfers relinquishing control, that the jury verdict in favor of the Government embraces such a finding, and that the Circuit Court of Appeals was powerless to disregard that verdict which was supported by substantial evidence. In short, our position is that the so-called sales lacked reality in the same way that the sales between husband and wife were held to lack reality in *Mitchell* v. *Commissioner*, 89 F. (2d) 873, 874–875 (C. C. A. 2d), certiorari denied, 302 U. S. 723 (reversed on other issues, *sub nom. Helvering* v. *Mitchell*, 303 U. S. 391).

On this branch of the case there is likewise no necessity for disregarding the corporate fiction any more than there is need for merging the personalities of the spouses in the *Mitchell* case. The essential element in both is the absence of genuineness of the sales as evidenced by the vendor's intention not to relinquish dominion. This is a question of fact, and the jury verdict should not have been disturbed.

The District Court's charge to the jury on this issue indicates throughout (R. 164 *et seq.*) that he was asking it to determine the bona fides of these transactions. He had denied the Government's request for a directed verdict (R. 159), and was treating the case as one that should turn upon the particular facts. We believe that he erred in refusing to grant that request, and our Point I attempts to demonstrate why it should have been granted. But even assuming that he correctly turned the case over to the jury, we submit that its verdict should be conclusive. He instructed the jury "to ascertain whether there was in truth and in fact an actual and substantial sale" (R. 172), and charged that "a mere gesture without the vital intent to change ownership is not to be recognized as a sale merely because the transaction has some of the appearances of a sale" (R. 173).

The jury's general verdict represents a finding that there was no genuine sale, that the taxpayer had no real intention of relinquishing dominion over the securities. And such a conclusion is supported by an overwhelming mass of evidence in the record, including the circumstances surrounding the nature of the alleged delivery, together with the entire panorama of dealings between the taxpayer and Innisfail from the date of its creation, in which the respondent persistently treated securities standing in the name of Innisfail as his own, and in which appearances were maintained merely by

meaningless book entries. The court below, therefore, plainly erred when it brushed aside the verdict of the jury. Cf. *McCaughn* v. *Real Estate Co.*, 297 U. S. 606; *Helvering* v. *Nat. Grocery Co.*, 304 U. S. 282.

CONCLUSION

The decision of the court below is erroneous and should be reversed.

Respectfully submitted.

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